

Japan Equities

The Japan equity market underwent significant volatility in the first quarter due to the coronavirus pandemic and concerns about its impact on the global economy. The sell-off was indiscriminate and across all sectors, with little differentiation between the higher quality, well-managed companies that we own and their less attractive peers.

Although it was frustrating to see the widespread market carnage and the impact on our short-term performance, the panic-selling created an opportunity for us to add to our conviction stocks at attractive valuations. Since then, some of our holdings have subsequently rebounded (although it is too early to call an end to the coronavirus market panic).

After every crisis in Japan's history – including the Global Financial Crisis (GFC) in 2008 and the Tōhoku earthquake and tsunami in 2011 – the behaviours of consumers and corporations fundamentally changed. In light of the current global health crisis, we tried to envision any positive developments that might arise from the situation and sought to identify companies that could benefit.

For example, the percentage of workers equipped with remote-working capabilities in Japan is currently below 20%¹. We believe this will inevitably rise, leading to higher expenditure on technology-related goods and services. As we adapt to the new norms of social distancing measures and travel restrictions, the use of e-commerce, digital payments, telemedicine, cloud services, virtual and online entertainment, and online education platforms have accelerated – and are likely here to stay.

In the midst of such uncertainty, we believe our Japan portfolio is well-positioned. Our investment approach is inherently conservative and more than 80% of our portfolio companies have a secure net cash position. In a world awash in high levels of debt, we believe these companies should offer a reasonable amount of downside protection.

A large portion of the portfolio is invested in purely domestic companies with higher visibility with regards to demand. This includes drugstores and discount food retailers offering daily necessities, software and technology solutions providers operating a recurring revenue model, and online platforms in e-commerce and digital payments. We believe they should remain resilient in the event of a global recession.

Risk Factors

This document is a financial promotion for The First State Japan Strategy. This information is for professional clients only in the EEA and elsewhere where lawful. Investing involves certain risks including:

- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- **Currency risk:** Changes in exchange rates will affect the value of assets which are denominated in other currencies.
- **Single country / specific region risk:** Investing in a single country or specific region may be riskier than investing in a number of different countries or regions. Investing in a larger number of countries or regions helps spread risk.
- **Smaller companies risk:** Investments in smaller companies may be riskier and more difficult to buy and sell than investments in larger companies.

Reference to specific securities or companies (if any) are included to explain the investment strategy and should not be construed as investment advice, or a recommendation to invest in any of those companies.

For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document for each Fund.

If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

¹ Source: Ministry of Internal Affairs and Communications (MIC): 2018 Communications Usage Trend Survey (Company Edition)



Among our portfolio holdings with high overseas exposure, we have invested in leading Asian consumer franchises, global medical equipment manufacturers, factory automation companies, and other technology leaders. They are all high-quality companies with dominant market share in their respective niche industries and reinforced by solid balance sheets.

Despite shorter-term disruptions, we remain confident that our portfolio companies can bounce back from adversity and become even stronger after the crisis.

Adding to high conviction companies

Earlier this year and in anticipation of a sharp slowdown, we evaluated our portfolio holdings, looking for companies that we believe should remain relatively defensive. We took advantage of the market volatility to consolidate the portfolio into higher conviction ideas and purchase companies on our watch list that had become more reasonably valued.

Among the companies we added to were Welcia, Japan's largest drugstore operator, and MonotaRO, Japan's largest maintenance, repair and operations (MRO) e-commerce platform. Both companies proved to be highly defensive and benefited from increased demand for hygiene and healthcare products amid coronavirus concerns. Notwithstanding the temporary sales boost, we believe the long-term investment case for both companies – as the leading players in their respective industries – remains intact.

Welcia's business model is bearing fruit and its performance is starting to diverge from competitors. Welcia offers one-stop solutions for consumers, with a particular focus on dispensary/pharmacy services (a sizeable market worth JPY7.5 trillion²). While its drugstore peers dismissed the idea of dispensing prescriptions due to high initial costs, Welcia made upfront investments and has become one of the largest dispensaries in the country.

Although Welcia's market share of the prescription drug market by revenue is still 2%, it has only recently started to benefit from the change in consumer behaviour and the increased use of dispensaries near their homes. This trend is in accordance with government policies to promote the use of community-based healthcare (as opposed to hospitals and clinics); therefore, we believe there is still room to grow. Around 7% of the JPY6.5 trillion³ drugstore market is prescription sales, of which Welcia already takes a 31% share. We believe Welcia should continue to gain share in a consolidating market, due to its strong brand and established infrastructure.

At MonotaRO, we believe there is still a long runway of growth ahead, as it continues to gain market share in the fragmented MRO industry. Compared to 30% e-commerce penetration

in the overall business-to-business (B2B) market, e-commerce penetration in the MRO segment is only 10%⁴. We believe the pandemic will likely accelerate the shift towards online purchases, particularly when factoring in economies of scale and the benefit of lower procurement costs. Amazon has proven to be less of a competitive threat than previously anticipated, as MonotaRO holds a stronger presence in the B2B sector.

We also topped up our position in OBIC, Japan's largest enterprise resource planning (ERP) systems provider, which we wrote about in detail in a previous note. OBIC has been resilient in the current market environment and has performed steadily in previous downturns. Operating profit has grown consistently for the last 22 years, including the GFC and the Tōhoku earthquake periods.

Recurring revenue businesses have continued to grow, with cloud services and on-premises support accounting for 39% of sales and 48% of operating profit. With more people working from home, we expect cloud-based services to become an increasingly larger business.

Similarly, we took advantage of market weakness to add to Benefit One, which provides membership benefits (such as travel management and healthcare) to corporate clients. The majority of Benefit One's revenue is recurring and has grown by around 11% a year for the last five years.

Despite the short-term sell-off, we believe the longer-term investment case for Benefit One remains solid and the company could become much bigger in five years' time. While Japanese companies and government entities have traditionally provided welfare services for their employees in-house, Benefit One has become a major outsourced supplier of value-add services to the employee, while also saving costs for the employer. In addition to fringe benefits, the CEO has communicated his vision for newer platform businesses, such as payment settlements and healthcare.

We also added to GMO Payment Gateway, the largest online payment processing company in Japan. GMO Payment's driven and capable management team is headed by President Mr Ainoura and Vice President Mr Muramatsu, former CEOs of Card Call Service and Payment One – the two companies that merged 14 years ago to form GMO Payment. As a growth-oriented company focused on sustainable growth over the medium to long term, the management are committed to delivering 25% compounded annual profit growth over the next five years.

One of the key risks for GMO Payment is if its biggest clients start to process payments in-house after reaching a certain scale. This was the main reason behind GMO Payment's revenue slowdown

² Source: Ministry of Health, Labour and Welfare: *2018 Trends in Dispensing Medical Expenses*

³ Source: Ministry of Economy, Trade and Industry: *Preliminary Report on the Current Survey of Commerce, March 2020*

⁴ Source: Ministry of Economy, Trade and Industry: *2018 Infrastructure Development for a Data-Driven Society in Japan (Market Research on Electronic Commerce)*



in 2019, as companies like Rakuten and Mercari shifted some of the services previously provided by GMO to an internal division.

However, we believe there is still plenty of room for GMO Payment to grow, as e-commerce penetration in Japan is only 7%⁵ of retail sales. With more offline retailers and consumer brand companies launching e-commerce portals, we believe GMO Payment is well-positioned to capture the market, due to its extensive experience and track record in the payments industry.

The emergence of cashless payment transactions could be another growth driver for GMO Payment. Japan's cashless payment penetration is relatively low at 18%⁵ compared to countries such as South Korea (95%), the UK (67%) and the US (44%). Recent policies, such as merchant subsidies and consumer rewards programs (which have been primary catalysts in other nations), are expected to accelerate the pace of transition. This could open doors to larger addressable markets, such as the offline cashless payment (JPY300 trillion) and the public tax/utilities market (JPY100 trillion).

New positions

As bottom-up investors, we do not rely on benchmark indices or sectors to construct portfolios. Investment ideas are generated by meetings with company management, followed by detailed fundamental research and analysis on companies we might want to invest in. The recent market volatility allowed us to buy high quality stocks on our watch list that we had followed for some time, but were too expensively valued in the past.

Among the new positions was Hoya, a leading manufacturer of lenses and related optical products. Having observed its performance over time, we increasingly appreciated its corporate philosophy of being a *"big fish in a small pond"* and its strong focus on corporate governance and shareholder returns. Unusual in a Japan context, Hoya has a strong profit-centric culture and its track record has been consistently good.

Over the past 10 years, total shareholder return was 78% of free cash flow after acquisitions (Hoya's policy is to return all excess free cash flow to shareholders after budgeting for capital expenditures and acquisitions), or 73% as a proportion of net income. On top of that, Hoya has JPY290 billion net cash on its balance sheet (or 9% of market cap). The board believes this is too high, which means we should probably expect to see share buybacks in future.

Hoya's business can be categorised into two major divisions: Life Care and Information Technology (IT). In the IT segment, which focuses on glass-related products used in the technology manufacturing process, Hoya has developed a near monopoly in

certain materials, such as Extreme Ultraviolet (EUV) mask blanks used in the production of semiconductors, and glass substrates used in Hard Disk Drives (HDD).

Hoya generates 40-50% operating profit margin (OPM) on these products, as there is virtually no competition. As semiconductor leaders Taiwan Semiconductor (TSMC) and Samsung start to migrate their chip production to more advanced and smaller nodes, we believe that average selling prices (ASPs) for Hoya's EUV products should rise. Hoya expects to double the capacity of both products over the next few years.

We also purchased Olympus, the largest medical equipment company in Japan with 70% global market share in gastrointestinal endoscopes⁶. Despite its strong franchise, we have been concerned in the past with its complacent culture and low profitability. However, we believe there are positive changes underway: Olympus has replaced the majority of its senior leadership team with externally-hired managers, which should bring fresh new perspectives, as well as the ability to make drastic changes where it is needed.

The executive management team now consists of five key people in CxO⁷ leadership positions, thus streamlining the decision-making process. In addition, the core Medical business has been restructured and simplified from five divisions into two, with Endoscopic Solutions managed from Japan and Therapeutic Solutions to be managed from the US.

After the reorganisation, Olympus' strategy has refocused on strengthening its leadership in gastrointestinal endoscopes. It is investing in China, where the overall penetration of gastrointestinal endoscopy is low, by increasing its training programs to resolve the bottleneck of insufficiently qualified doctors (China has only 22 endoscopists per million people, compared to 250 per million in Japan⁸). Chinese government policies to promote endoscopic diagnosis support its penetration into mid-tier hospitals, which should increase demand for Olympus' products exponentially.

In addition, Olympus has committed to controlling costs in order to improve margins and profitability. The majority of Olympus' consolidated profit comes from its Endoscopic Solutions segment, which generates around 29% OPM. However, Olympus' consolidated OPM is only 9% - much lower than global peers (Medtronic, Stryker and Johnson & Johnson all generate OPM above 20%).

Olympus aims to improve its OPM to 20% by fiscal year (FY) 2023. We continue to monitor the progress, as we believe that there could be considerable upside if Olympus can execute its transformation plan. While it is early days and there is still much

⁵ Source: GMO Payment Gateway, February 2020

⁶ Source: Olympus, November 2019

⁷ C-level corporate executives

⁸ Source: Olympus, November 2019



to be done, we believe the direction of travel is encouraging. The position is a relatively modest one, though we have been adding on weakness.

What we sold and lessons learned

We sold Relo Group and BeNEXT to make room in the portfolio for the companies mentioned above. Both companies had been pursuing lower quality growth, in our view, with overseas acquisitions diluting earnings and distracting management from the main local business.

Relo Group is a leading corporate services company, providing leased housing, global relocation services and fringe benefits. We initially bought Relo for its recurring revenue model, which offers stable earnings growth and downside protection during economic downturns, as demonstrated during the GFC.

However, we started to question the investment case amid signs that the company had bigger ambitions for its global relocation services. In particular, Relo's large overseas acquisition in 2019 of a global relocation business caught our eye. The purchase price was expensive at 139x price-to-earnings ratio (PER) and it led to a spike in Relo's financial leverage. Like many Japanese companies who remain passive investors of their overseas purchases, Relo's culture did not seem globally-savvy enough to transform the acquired business.

As such, we had been reducing our position in Relo since last year, in favour of Benefit One. As the coronavirus started to spread, our portfolio review led us to completely sell out of Relo as we considered the impact of a recession on its global relocation business – and, given that better-quality companies could be purchased at bargain prices amid the market sell-off.

Similarly, BeNEXT's overseas acquisitions have been a major concern on profitability. We initially believed that BeNEXT, which primarily dispatches engineers in Japan (88% of operating profit), should benefit from increasing labour shortages in this particular sector.

In hindsight, we should have exited this position when we noticed BeNEXT's longer-term ambitions on making overseas acquisitions. Instead, we held on to it because of its cheap relative valuation, even though we increasingly had concerns about the quality of its business. Similar to Relo, Covid-19 aggravated the risks of BeNEXT's overseas exposure (Nissan Motor in the UK) and its manufacturing staff dispatching business, both of which are macro-sensitive.

Among engineering dispatch companies, we have greater conviction in TechnoPro, with its longer-term mindset (the company trains its engineers in more advanced skills) and its higher exposure to IT engineers (50% in headcount terms, compared to BeNEXT's 20% mix), where demand has been resilient and growing rapidly.

Both Relo Group and BeNEXT seemed to be cheaper than peers, which initially gave us comfort as lower valuations provide a greater 'margin of safety'. However, as we subsequently realised, optically-cheap companies do not necessarily protect capital.

Most investors look at companies in a much too simplistic way: growth vs value. However, in reality, all investors should be looking for value; that is, to buy companies where the market value is below intrinsic value. But, a lower price-to-earnings ratio (PER) or price-to-book (P/B) valuation, based on 12-month earnings or book value, does not mean that a company is cheap, nor that there is more value to realise compared to companies at a higher PER or P/B. The issue with these ratios is that they cannot capture a company's long-term profit/cash flow growth, nor its resilience during economic recessions.

We look at valuations from a more holistic perspective and believe that quality companies can justifiably command a premium – particularly those that have these three qualities concurrently: 1) high return on invested capital; 2) strong and sustainable growth; and 3) high earnings visibility, supported by a strong franchise and management team.

Our portfolio holdings generate 37% weighted average ROIC, indicating that these companies have higher profits that can either be reinvested for long-term growth or be returned to shareholders. We also believe companies with a high-calibre franchise or management team warrant a lower discount rate (cost of capital) because earnings visibility is higher. As such, the best-performing companies in the current down-market have typically had higher valuations relative to the market – which is what we have experienced in our Japan portfolio.

Interestingly, for some of our high-conviction holdings, it is difficult to pinpoint a single numerical value based on today's business. These companies evolve over time, as the management invent new business lines to grow earnings. For example, M3 started by offering pharmaceutical marketing services (information on drugs that is emailed to doctors). However, 20 years later, its services include contract research, job placement and medical records software. The pharmaceutical marketing segment now accounts for only 16% of M3's consolidated sales.

As part of our investment approach, we are disciplined in conducting regular fair market valuation reviews; however, our conviction in a company's franchise, management and sustainability of growth plays an equally important role in our holistic investment decision-making process.

Performance review

The top contributors to performance year-to-date are the same companies that we had added to during the sell-off – MonotaRO, GMO, Welcia, OBIC and M3. Though they were sold off along with the market, they subsequently rebounded, as investors realised there should be little negative fallout from the coronavirus.



Out of the companies that performed poorly – BeNEXT, Fast Retailing, Recruit Holdings, SMS and Workman – we sold BeNEXT, as mentioned earlier, but we remain long-term owners of the rest and have been adding on weakness.

Workman and Fast Retailing (UNIQLO) specialise in selling quality, affordable clothing. They were highly defensive during previous economic recessions as their stores attracted price-conscious customers. However, Covid-19 has particularly affected discretionary retailers due to a weaker consumer appetite and widespread store closures. Even so, while these short-term disruptions undoubtedly affect earnings, they are temporary in nature and, in our view, do not affect the long-term investment case.

We believe the Workman Plus brand should continue to strengthen, as affordable, functional apparel continues to grow in popularity among deflationary-minded Japanese consumers. Fast Retailing, led by a passionate and visionary founder, has a strong franchise supported by solid brand equity and a decent growth outlook both domestically and overseas. Both companies generate the highest ROIC among industry peers – Workman’s ROIC is 34%, while Fast Retailing yields 38% ROIC, indicating a strong foundation for sustainable growth.

Despite being recruitment-related businesses, Recruit Holdings and SMS proved to be resilient in previous economic downturns relative to competitors. SMS only hires nurses and careworkers – roles that enjoy strong demand irrespective of the economic cycle, due to Japan’s ageing population and labour shortages in the care sector.

Recruit Holdings is not only a recruitment company, it also runs various online media portals – the equivalent of Yelp (online local business reviews) and Expedia (online travel agency) in Japan. The marketing media business accounts for 38% of earnings before interest, tax, depreciation and amortisation (EBITDA), online job advertising and recruitment accounts for another 38%, and the general staffing business is around 24%.

Due to Covid-19, most job interviews have been delayed or cancelled – companies do not want to host face-to-face meetings and they have been reluctant to shift the process completely online. In addition, restaurants and the travel industry were hard hit, which affected Recruit’s business as well.

However, SMS and Recruit are both leading franchises operated by capable management. We believe SMS will likely remain a key beneficiary of structural labour shortages in the niche care sector; and Recruit’s asset-light model, entrepreneurial culture and track record of achieving a leading market share in its domain

bodes well for future growth. As consolidation in each industry accelerates due to Covid-19, we believe stronger companies such as SMS and Recruit should increase their leadership over peers.

Annual Performance (% in GBP)

As of 31 March 2020	12mths to 31/03/20	12mths to 31/03/19	12mths to 31/03/18	12mths to 31/03/17	12mths to 31/03/16
Fund return	10.1	-2.8	25.8	23.1	-
Benchmark return	-1.9	-0.8	6.6	31.5	-

Cumulative Performance (% in GBP)

As of 31 March 2020	3mths	6mths	1yr	3yrs	5yrs	10yrs	Since Inception
Fund return	-9.5	-8.1	10.1	34.6	-	-	91.9
Benchmark return	-11.1	-11.0	-1.9	3.8	-	-	35.6

These figures refer to the past. Past performance is not a reliable indicator of future results. For investors based in countries with currencies other than GBP, the return may increase or decrease as a result of currency fluctuations.

Last words

In the throes of a downturn, pessimism is abound, which is understandable and expected. But the Chinese word for “crisis” (危機), which consists of two letters with opposite meanings – danger and opportunity – suggests that we should look at the status quo from another perspective. Likewise, great investors in history exploited market volatility in a downturn, which ultimately generated superior returns.

We have two observations on the companies that have been resilient (so far) during Covid-19. The first type are those that have already built a dominant franchise and are best positioned in a Darwinian world, where survival of the fittest is the name of the game. The other type are those leading the disruption in their respective industries, either by innovating or helping others adopt better business processes. Regardless of the type, capable management, whether charismatic or visionary, is indispensable to creating successful companies.

It is the darkest nights that produce the brightest stars; and our findings remind us that our investment philosophy of focusing on high-quality companies with strong franchises, financials and management is for the benefit of long-term returns and in the best interest of our clients, especially during times of turmoil. As we stay true to our colours, we will continue to invest in companies that we believe can spot and grasp opportunities in the midst of a crisis.



Important Information

This document has been prepared for informational purposes only and is only intended to provide a summary of the subject matter covered. It does not purport to be comprehensive. The views expressed are the views of the writer at the time of issue and may change over time. It does not constitute investment advice and/or a recommendation and should not be used as the basis of any investment decision. This document is not an offer document and does not constitute an offer or invitation or investment recommendation to distribute or purchase securities, shares, units or other interests or to enter into an investment agreement. No person should rely on the content and/or act on the basis of any material contained in this document.

This document is confidential and must not be copied, reproduced, circulated or transmitted, in whole or in part, and in any form or by any means without our prior written consent. The information contained within this document has been obtained from sources that we believe to be reliable and accurate at the time of issue but no representation or warranty, express or implied, is made as to the fairness, accuracy, or completeness of the information. We do not accept any liability whatsoever for any loss arising directly or indirectly from any use of this information.

References to “we” or “us” are references to First State Investments.

In the UK, issued by First State Investments (UK) Limited which is authorised and regulated by the Financial Conduct Authority (registration number 143359). Registered office Finsbury Circus House, 15 Finsbury Circus, London, EC2M 7EB number 2294743. Outside the UK, issued by First State Investments International Limited which is authorised and regulated in the UK by the Financial Conduct Authority (registered number 122512). Registered office: 23 St. Andrew Square, Edinburgh, EH2 1BB number SCO79063.

Certain funds referred to in this document are identified as sub-funds of First State Investments ICVC, an open ended investment company registered in England and Wales (“OEIC”) or of First State Global Umbrella Fund, an umbrella investment company registered in Ireland (“VCC”). Further information is contained in the Prospectus and Key Investor Information Documents of the OEIC and VCC which are available free of charge by writing to: Client Services, First State Investments (UK) Limited, Finsbury Circus House, 15 Finsbury Circus, London, EC2M 7EB or by telephoning 0800 587 4141 between 9am and 5pm Monday to Friday or by visiting “<http://www.firststateinvestments.com>” www.firststateinvestments.com. Telephone calls may be recorded. The distribution or purchase of shares in the funds, or entering into an investment agreement with First State Investments may be restricted in certain jurisdictions.

Representative and Paying Agent in Switzerland: The representative and paying agent in Switzerland is BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, 8002 Zurich, Switzerland. Place where the relevant documentation may be obtained: The prospectus, key investor information documents (KIIDs), the instrument of incorporation as well as the annual and semi-annual reports may be obtained free of charge from the representative in Switzerland.

First State Investments entities referred to in this document are part of First Sentier Investors a member of MUFG, a global financial group. First Sentier Investors includes a number of entities in different jurisdictions, operating in Australia as First Sentier Investors and as First State Investments elsewhere. MUFG and its subsidiaries do not guarantee the performance of any investment or entity referred to in this document or the repayment of capital. Any investments referred to are not deposits or other liabilities of MUFG or its subsidiaries, and are subject to investment risk including loss of income and capital invested.

The First State Investments logo is a trademark of the Commonwealth Bank of Australia or an affiliate thereof and is used by FSI under licence.

Copyright © (2020) First Sentier Investors
All rights reserved.